2.05 Revenue Recognition Step 5 & Disclosures

5. Recognizing Revenue as Performance Obligations are Satisfied

Revenue is recognized when a performance obligation is satisfied or, in some circumstances, while it is being satisfied.

A performance obligation is considered satisfied when the entity has transferred the promised goods/services to the customer, which occurs **at a point in time** when the *customer has control* of those goods/services.

A **customer has control** over goods and services when the customer can:

- Direct the use of the goods/services,
- Prevent others from benefitting from them, and
- Obtain benefits from the goods/services in the form of cash flows (ie, inflows or savings).

When **control is uncertain**, other factors to consider include whether customer has:

- Legal title to goods
- Physical possession of the goods
- Significant risks and rights associated with ownership of the goods
- Accepted the goods

Revenue may be recognized while the performance obligation is being satisfied if the goods/services promised are transferred to the customer **over time**. This is determined at the inception of the contract based on the existence of one of three conditions:

- The customer consumes the goods/services as they are being delivered.
- The customer has control over the asset while it is being created or enhanced.
- The entity has no alternative use for the goods/services and is entitled to payment for performance completed to date.

Consuming Goods or Services Upon Delivery

Certain performance obligations, by their natures, are being consumed as they are being delivered. This is generally true of recurring services being provided to a customer, such as cleaning services.

Sometimes it is hard to determine whether goods/services are being consumed as they are being delivered. In such cases, one should ask: if another entity were engaged to complete the performance obligation, would they need to substantially reperform what the original entity completed? If yes, the customer has not been consuming the goods/services. If not, then the customer has been consuming the goods/services upon delivery.

Customer Control Over Asset

In determining whether the customer controls an asset while it is being created or enhanced, the same criteria that are used to determine whether control has been transferred to the customer should be applied.

Lack of Alternative Use and Entitlement to Payment

An asset is considered to not have an alternative use to the seller if the seller would be required to dispose of it at a substantial cost. For example:

- The entity would not be able to transfer the goods/services to another customer (perhaps due to unique design specifications), or they would incur a significant loss to do so.
- Significant costs would be incurred to rework the asset in order to apply it to another use.

Assuming the contract was terminated for a reason other than the entity's inability to complete performance, the entity must also be entitled to payment for work completed to date. The amount should reflect the approximate selling price of the goods/services transferred. That is, the entity should be entitled to recover its costs plus a reasonable profit; the profit, however, need not be equal to that which would have been earned upon completion.

Recognizing Revenue While Performance Obligation is Satisfied

In order to recognize revenues while the performance obligation is being satisfied, there must be some means for measuring progress toward completion of the obligation. The two acceptable methods for measuring progress are the output method and the input method.

Output Method

The focus of the output method is the *value the customer derives* from the goods/services that have been transferred to the customer up to that point. When using the output method, the entity should select a base to use for measuring progress that faithfully reflects the entity's performance toward completion. Alternatives may include:

- Surveys, such as engineering studies, of the work completed
- Appraisals of results achieved
- Milestones reached
- Time elapsed
- Units produced or delivered

In some cases, contracts call for consideration on the basis of some criteria, such as the number of hours a professional works on a project that is being billed on an hourly basis. When there is such a measurement guideline, it may also be used as a basis for measuring outputs.

The output method is not always the most practical or reliable way to measure progress and some situations require the use of the input method. This may be the case, for example, when progress is not necessarily observable or when the information necessary to apply the output approach is not readily available.

Input Method

The focus of the input method is the *effort put forth by the entity*. Measurement may be based on a wide variety of inputs, including:

- Resources consumed
- Labor hours expended
- Costs incurred
- Time elapsed
- Machine hours used

If an entity's inputs are expended or efforts are put forth somewhat uniformly over the period during which the performance obligation is being satisfied, it may be appropriate to recognize revenue on a straight-line basis over such period.

The input method may not be appropriate in all circumstances. This would be true, for example, for contracts where there is no direct relationship between the inputs used by the entity and the transfer of benefits to the customer.

Inputs that do not depict the entity's performance should be excluded when applying the input method. For example, when using costs incurred as the basis for measuring progress, adjustments may be required for:

- Cost incurred that do not contribute to the progress toward completion, such as amounts spent for an unanticipated high amount of waste
- Costs that are incurred disproportionately with progress toward completion

Licensing

When revenue is generated by granting a license to use intellectual property, the method used to recognize revenue will depend on the nature of the licensing arrangement—that is, whether it grants a *right to use* the intellectual property or a *right to access* intellectual property.

- When a license grants the customer the **right to use** intellectual property (eg, a photo), it is assumed that the property is functional as is and that the licensor does not have any obligation to maintain the property; thus, revenue will be recognized **at a point in time** (ie, when the property is made available for use).
- When a **right to access** intellectual property is granted to a customer, the customer will have access to the property for a period of time and the licensor will usually have an obligation to support or maintain the intellectual property during that time. Since the performance obligation largely consists of the duty to support and maintain the intellectual property over a period of time, revenue will be recognized **over the term of the license**.

Onerous Performance Obligations

If, at any time, the expected cost of satisfying a performance obligation (or contract) is greater than the amount of revenue allocated, it is referred to as an onerous performance obligation (or contract). The entity will **recognize the expected loss and a corresponding liability immediately**.

- Applies to construction-type and production-type contracts (ASC 605-35).

Accounting for Costs Incurred

Costs incurred in satisfying a performance obligation will be accumulated and reported on the income statement in the period in which the related revenues are recognized. Generally, costs of obtaining a contract will be recognized as expenses in the period in which they are incurred. Certain costs, however, should be capitalized.

- **Recoverable incremental costs of obtaining a contract** are capitalized until the related revenue is recognized on the income statement. For example, a land broker may pay to have land rezoned to increase the value of the property. These costs are incremental costs of obtaining the contract that should be capitalized because they will be recovered when the broker sells the property.
- **Certain costs are required by various standards** to be capitalized while others are required to be expensed.
- **Costs meeting all of the following criteria** are required by the revenue recognition standards to be capitalized:
    - The costs relate directly to a contract that is in existence or a specific contract that is currently being negotiated;
    - The costs generate or enhance resources that will be used to satisfy performance obligations in the future; and
    - The costs are expected to be recovered.

Recovery of costs may be through collections of revenues on the contract if they were anticipated when the contracts were negotiated, or they might have resulted from changes made to the performance obligation that are reimbursable by the customer.

Disclosures

The objective of the revenue recognition disclosure requirements is to disclose sufficient information to enable users of F/S to understand the *nature, amount, timing,* and *uncertainty* of *revenue* and *cash flows* arising from contracts with customers. To achieve this, an entity should provide qualitative and quantitative disclosures regarding:

- Contracts with customers
- Significant judgments (and any changes) made in applying the revenue recognition rules to those contracts
- Assets recognized from the costs to obtain or fulfill such contracts

The disclosures will generally be in the footnotes to the F/S. They may be in a separate footnote devoted exclusively to revenue recognition or may be included in a more general footnote, such as the summary of significant accounting principles.

Both public and nonpublic entities are required to provide information about disaggregated revenues, contracts balances, and performance obligations:

- If the entity elects not to provide information about disaggregated revenues that is required for public entities, it should disclose, as a minimum, revenues that are disaggregated according to the timing of the transfers of goods/services and qualitative information about how economic factors affect the nature, amount, timing, and uncertainty of revenue and cash flows

- Opening and closing balances of receivables, contract assets, and contract liabilities, unless otherwise provided on the F/S
- When the entity typically satisfies its performance obligations
- Significant payment terms
- The nature of the goods/services the entity has promised to deliver, emphasizing obligations to arrange for delivery by another entity when the reporting entity is acting as an agent
- Obligations related to returns, refunds, and similar items

Public entities are also required to provide the following disclosures:

- Information about disaggregated revenues in categories that show how the nature, amount, timing, and uncertainty are affected by economic conditions
- A reconciliation of the disaggregated revenues to the amount reported in various segments if the entity is reporting segment information
- Revenues recognized from contracts with customers, distinguished from revenues from other sources
- Impairment losses recognized on receivables or contract assets derived from transactions involving revenues from contracts with customers
- Information about the timing of the satisfaction of performance obligations and the its relationship to the timing of payments, along with their effects on contract assets and contract liabilities
- Qualitative and quantitative information explaining significant changes in contract assets and contract liabilities during the period including, as appropriate:
    - Changes due to business combinations
    - Cumulative catch-up adjustments due to changes to the measurement of progress toward completion; estimates of the contract price, including those related to variable revenues or the constraint on variable revenues; and contract modifications
    - Contract asset impairments
    - Changes affecting the time for a right to compensation becoming unconditional and being reclassified from a contract asset to a receivable
    - Changes to the time expected to be required for satisfaction of a performance obligation
    - Types of warranties and related obligations

While a nonpublic entity may elect not to disclose it, if a public entity has a performance obligation that is part of a contract that has an original expected duration of more than one year, and it does not have the right to consideration in an amount that exactly equals the value to the customer of the entity's performance to date, the entity will disclose:

- The aggregate amount of the transaction price allocated to performance obligations not satisfied as of yearend; and
- An indication as to when the entity expects to recognize that amount as revenue, either:
    - Qualitatively or
    - Quantitatively, using time bands most appropriate for the duration of the remaining performance obligations